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No. 90-516

IN THE

Supreme Court Of The United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC. and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ of Certiorari To The United States
Court of Appeals For The Seventh Circuit

MOTION FOR LEAVE TO FILE BRIEF, AMICUS CURIAE,
and
BRIEF, AMICUS CURIAE,
OF THE INVESTMENT COMPANY INSTITUTE
IN SUPPORT OF RESPONDENTS

MATTHEW P. FINK
Senior Vice President
and General Counsel
CRAIG S. TYLE
Associate General Counsel
INVESTMENT COMPANY
INSTITUTE
1600 M Street, N.W.
Suite 600
Washington, D.C. 20036
Of Counsel

February 19, 1991

HARVEY L. PITT*
(*Counsel of Record)
JAMES H. SCHROPP
PETER M. SHERMAN
MARY A. WALLACE
FRIED, FRANK, HARRIS,
SHRIVER & JACOBSON
1001 Pennsylvania Avenue, N.W.
Suite 800
Washington, D.C. 20004
(202) 639-7000

Attorneys for Investment
Company Institute

Balmar Legal Publishing Divison, Washington, D.C. 20005 (202) 659-3610

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MOTION FOR LEAVE TO FILE BRIEF, AMICUS CURIAE

Pursuant to Rules 21.2(b) and 37.4 of this Court's Rules, the Investment Company Institute (the "Institute") hereby respectfully moves for leave to file the attached brief, *amicus curiae*, in the above-captioned case. The respondents have consented to the filing of such a brief; the petitioner has declined to consent to the filing of this brief.

The Institute is the national association of the American investment company industry. The Institute's membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advisers and principal underwriters and sponsors of unit investment trusts. The Institute regularly engages in legislative and private-sector initiatives relating to the welfare of investment companies and their shareholders, and continually assesses the adequacy of existing protections of investment companies and their shareholders.

The Institute has a substantial interest in this case because of its significance to investment companies. The Institute is concerned that, to the extent a board of directors of an investment company is deprived of the opportunity to consider whether claims should be asserted in the name of the company, this will result in an evisceration of the statutory role of independent investment company directors, to the detriment of investment companies and their shareholders, and will subvert clearly articulated Congressional intent. Leave of this Court is sought to offer the Institute's unique perspective on the proper resolution of the important issues raised by the parties, so that the decision in this case can most effectively be reconciled with the structure and purposes of the Investment Company Act of 1940.

For the foregoing reasons, the Institute should be permitted to file the attached brief, *amicus curiae*.

Respectfully submitted,

/s/ HARVEY L. PITT

HARVEY L. PITT*
(*Counsel of Record)
JAMES H. SCHROPP
PETER M. SHERMAN
MARY A. WALLACE
FRIED, FRANK, HARRIS,
SHRIVER & JACOBSON
1001 Pennsylvania Avenue, N.W.
Suite 800
Washington, D.C. 20004
(202) 639-7000

Attorneys for Investment Company Institute

February 19, 1991

QUESTIONS PRESENTED FOR REVIEW

The Investment Company Institute adopts, by reference, the questions presented by the respondent Kemper Financial Services, Inc.

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BRIEF, AMICUS CURIAE, OF THE INVESTMENT COMPANY INSTITUTE IN SUPPORT OF RESPONDENTS

The Investment Company Institute (the "Institute") files this brief, *amicus curiae*, in support of the respondents' prayer that the judgment of the United States Court of Appeals for the Seventh Circuit, entered on July 18, 1990, be affirmed.

INTEREST OF THE INVESTMENT COMPANY INSTITUTE

The Institute is the national association of the American investment company industry. The Institute's membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advisers and principal underwriters and sponsors of unit investment trusts. The Institute regularly engages in legislative and private-sector initiatives relating to the welfare of investment companies and their shareholders, and continually assesses the adequacy of existing protections of invest-

ment companies and their shareholders. The Institute's investment company members are registered with the United States Securities and Exchange Commission (the "Commission" or "SEC") under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1, *et seq.* (the "Act" or "ICA"), and are subject to detailed statutory and regulatory prescriptions regarding their structure, operations and governance.[1]

The Institute has a substantial interest in this case because of its significance to investment companies. The Institute is concerned that, to the extent a board of directors of an investment company is deprived of the opportunity to consider whether claims should be asserted in the name of the company, this will result in an evisceration of the statutory role of independent investment company directors, to the detriment of investment companies and their shareholders, and will subvert clearly articulated Congressional intent.

For the reasons set forth below, the Institute respectfully submits that the decision of the court of appeals should be affirmed, because it is in accordance with well-settled principles of federal law, and because it is consistent with the provisions and policies of the Act.

STATEMENT OF THE CASE

The Institute adopts the statement of the case set forth in the Brief of the Respondent Kemper Financial Services, Inc. ("KFS").

SUMMARY OF ARGUMENT

The Institute believes that the decisions of both the district court and the court of appeals below, holding that the petitioner's Section 20(a) claim should be dismissed for failure to plead facts sufficient under federal law to excuse demand, were correct. A uniform rule, based in federal law, should be applied in considering whether demand should be required in shareholder derivative actions involving investment companies registered under the ICA.

[1] *See, e.g., Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984); *Burks* v. *Lasker*, 441 U.S. 471, 478 (1979).

Moreover, the Institute believes that the decision of the court of appeals, requiring a shareholder demand in all derivative actions raising federal claims, is appropriate as it relates to the potential claims of federally regulated investment companies. In light of the independent director provisions of the ICA, which guarantee the presence of a substantial percentage of directors with no interest in an investment company's adviser and contemplate that such directors should perform a "watchdog" function with respect to shareholder interests, it is appropriate that the Court require that claims should initially be presented to and reviewed by the investment company's board of directors.

Finally, the Commission's argument, as *amicus curiae*, that all Section 20(a) claims are "direct" rather than derivative in nature is not properly before this Court, and is, in any event, contrary to the prior holding of this Court and without merit. The Commission's proposed rule would leave the company, the party which often is the most adversely affected by proxy violations, without a remedy, and would deprive shareholders of the right to bring derivative actions in circumstances where such an action may be the only type of action that is appropriate.

ARGUMENT

I. Both Courts Below were Correct in Concluding that Petitioner Failed Sufficiently to Allege that Demand Would be Futile

Both the district court and the court of appeals held that the allegations of futility in the petitioner's complaint, that the directors of Cash Equivalent Fund, Inc. (the "Fund") (i) received fees for serving on the board, (ii) approved the allegedly misleading proxy statement, and (iii) caused the fund to seek dismissal of the petitioner's suit,[2] were "insufficient to excuse a demand."[3]

In this regard, the decisions of the courts below are firmly rooted in the longstanding rule developed by courts which have considered the parameters of a futility exception, pursuant to which demand will

[2] *See* Pet. App. 6a.

[3] *Id.*

not be excused unless a plaintiff demonstrates, with specific factual allegations, that an antagonism exists between the directors and the corporation to such a degree that it renders the directors incapable of fairly and effectively discharging their duties.[4] The pleadings must indicate that, due to personal bias, interest in a transaction or active participation by the directors in the alleged wrong, the directors are unlikely to act in the best interests of the corporation.[5]

Applying these well-settled principles, both courts below correctly determined that none of the petitioner's allegations suggested that the Board of Directors of the Fund was unlikely to render an informed and disinterested decision as to the petitioner's claim. The petitioner's allegations concerning the directors' remuneration deserve little consideration; nearly every director serving on a board is compensated for his or her services, and such claims are insufficient to establish futility.[6] Moreover, the petitioner's allegations concerning

[4] *See In Re Kauffman Mutual Funds Actions*, 479 F.2d 257, 263 (1st Cir. 1973), *cert. denied*, 414 U.S. 857 (1973). *See also Delaware & Hudson Co.* v. *Albany Susquehanna R.R.*, 213 U.S. 435, 447 (1909); *Gaubert* v. *Federal Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988); *Greenspun* v. *Del. E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980); *Heit* v. *Baird*, 567 F.2d 1157, 1160-62 (1st Cir. 1977); *Kaufman* v. *Kansas Gas & Elec. Co.*, 634 F. Supp. 1573, 1578 (D. Kan. 1986); *In Re Consumers Power Co. Derivative Litig.*, 111 F.R.D. 419, 423-24 (E.D. Mich. 1986); *Seidel* v. *Public Serv. Co.*, 616 F. Supp. 1342, 1351 (D.N.H. 1985); *Reilly Mortgage Group, Inc.* v. *Mount Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1077 (E.D. Va. 1983); *Stein* v. *Aldrich*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,473, at 92,780 (S.D.N.Y. Jul. 18, 1980); *Meyers* v. *Keeler*, 414 F. Supp. 935, 937 (W.D. Okla. 1976).

Although the possible application of state law in this case was not raised by the petitioner until her reply brief in the court of appeals, and thus is not properly before this Court, Maryland law is fully in accord with this principle. *See Parish* v. *Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 81-84, 242 A.2d 512, 544-45 (1968), *cert. denied*, 404 U.S. 940 (1971), *citing McQuillen* v. *National Cash Register Co.*, 22 F. Supp. 867, 874 (D. Md. 1938). *See also Zimmerman* v. *Bell*, 585 F. Supp. 512, 514 (D. Md. 1984) (futility is established under Maryland and federal law when a "complaint sufficiently alleges that the [director] defendants as a body actively participated in the alleged wrongdoing in order to perpetuate their control over the corporation").

[5] *See, e.g., Starrels* v. *First Nat'l Bank*, 870 F.2d 1168 (7th Cir. 1989); *Lewis* v. *Graves*, 701 F.2d 245 (2d Cir. 1983); *Greenspun*, 634 F.2d 1204.

[6] *See Burt* v. *Danforth*, 742 F. Supp. 1043, 1048 (E.D. Mo. 1990); *In Re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986); *Grobow* v.

the directors' "approval" of the dissemination of the Fund's 1984 proxy statement are similarly unconvincing, since acts complained of by a shareholder in a derivative suit will often carry some measure of prior approval, tacit or explicit, of the company's board of directors.[7] Courts have consistently rejected these claims,[8] as well as claims of futility based on boilerplate allegations that demand is tantamount to asking the directors to "sue themselves."[9] Finally, a corporation's defense of a derivative suit which was not preceded by a demand has likewise been determined not to excuse demand, principally because such defense does not, by itself, mean that the board would have failed to consider a demand in accordance with its fiduciary duties.[10]

The Commission, as *amicus curiae*, contends that state (*i.e.*, Maryland) law should be applied to determine whether demand should have been excused in this case, on the theory that matters of demand and futility concern the "substantive law of corporations." Commission Br. 16. The Institute believes, to the contrary, that federal law should govern questions relating to the demand requirement in cases brought in federal courts, at least where, as here, the claims are based on the ICA.[11] While lower courts have not always been clear as to

Perot, 539 A.2d 180, 189 (Del. 1988). *See also Panter* v. *Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981) (directors found independent since "they derived no income from Field's other than normal directors' fees").

[7] *See In Re Kauffman Mutual Funds Actions*, 479 F.2d at 265; *Kaufman* v. *Kansas Gas & Elec. Co.*, 634 F. Supp. at 1580.

[8] *See, e.g., Cottle* v. *Hilton Hotels Corp.*, 635 F. Supp. 1094, 1098 (N.D. Ill. 1986); *Gaubert* v. *Federal Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988); *Brickman* v. *Tyco Toys, Inc.*, 722 F. Supp. 1054 (S.D.N.Y. 1989); *Recchion* v. *Kirby*, 637 F. Supp. 1309, 1320 (W.D. Pa. 1986).

[9] *See, e.g., Lewis* v. *Graves*, 701 F.2d at 249; *Lewis* v. *Curtis*, 671 F.2d 779, 785 (3d Cir. 1982), *cert. denied*, 459 U.S. 880 (1982); *Cottle*, 635 F. Supp. at 1098; *Recchion*, 637 F. Supp. at 1320; *Pullman-Peabody Co.* v. *Joy Mfg. Co.*, 662 F. Supp. 32, 35 (D.N.J. 1986). *See also Zimmerman*, 585 F. Supp. at 514 (holding that under both Maryland and federal law, "merely naming the directors is not enough to establish that a demand would be futile").

[10] *See Gartenberg* v. *Merrill Lynch Asset Management*, 91 F.R.D. 524, 527 (S.D.N.Y. 1981); *Grossman* v. *Johnson*, 89 F.R.D. 656, 659 (D. Mass. 1981), *aff'd*, 674 F.2d 115 (1st Cir. 1982), *cert. denied*, 459 U.S. 838 (1982).

[11] The Commission relies on *Burks* for the proposition that demand and futility concern the "substantive law of corporations" and, accordingly, should be governed

which law they were applying, federal courts have often remarked that the record would not support a finding of futility under either state or federal law, thus noting the existence of a separate body of federal law on this issue.[12] Likewise, in this case, Maryland law is in accord with the federal common law applied by both courts below,[13] and recog-

by state law. Yet, *Burks* concerned the power of disinterested directors of an investment company to terminate derivative litigation, and thus concerned the "font of corporate directors' powers," *Burks*, 441 U.S. at 478, including the sustainability of the board's action under a substantive standard -- the business judgment rule and its various permutations — that implicates core principles of corporate law that historically have been determined under state law. Federal law does not provide comprehensive legal standards in this area; instead, "federal law * * * is largely prohibitory in nature — it often limits the exercise of directorial power, but only rarely creates it." *Burks*, 441 U.S. at 478.

By contrast, the futility exception is first and foremost a matter of the adequacy of the pleadings that principally relates to procedure. *See Meltzer* v. *Atlantic Research Corp.*, 330 F.2d 946, 948-49 (4th Cir. 1964), *cert. denied*, 379 U.S. 841 (1964). And unlike *Burks*, demand and futility are matters on which federal law provides an impressive history and comprehensive standards. Indeed, when this Court enforced a demand requirement in *Hawes* v. *Oakland*, 104 U.S. 450 (1881), it derived the requirement from considerations of federal law and policy. Thus, while the demand rule may have evolved out of the general proposition that, under state law, a corporation is managed by its board of directors, it has other historical antecedents and contemporary functions.

12 *See, e.g.*, *Gaubert*, 863 F.2d at 64; *Meltzer*, 330 F.2d at 948-49.

13 *See Zimmerman*, 585 F. Supp. at 514. The U.S. District Court for the Eastern District of Missouri has suggested that Maryland law is more liberal with respect to the recognition of a futility exception than federal law. *See Danforth*, 742 F. Supp. at 1047-49. The court stated that Maryland law finds demand futile "[w]hen the directors' prosecution of a plaintiff's claims would result in the directors' prosecuting themselves." *Id.* at 1047. However, it appears that the district court misread Maryland precedent; the cases cited by the *Danforth* court clearly require that the defendant directors be accused of fraud or other active participation in a transaction solely to further the individual interests of the directors. *See, e.g.*, *Parish*, 242 A.2d at 545; *Eisler* v. *Eastern States Corp.*, 182 Md. 329, 35 A.2d 118, 119 (1943). Thus, under Maryland law, demand will not be excused merely because the directors have been named as defendants; a plaintiff must also allege that the directors committed fraud or intentionally breached their fiduciary duties.

In any event, this is not a case in which the directors would have been required to "sue themselves." The petitioner herself has not sued the directors, but seeks recovery only against the adviser to the respondent mutual fund, an entity unaffiliated with a substantial majority of the fund's Board members. Indeed, Section 36(b)(3) of the Act precludes an action for damages against the members of the fund's board.

nizes futility only when fraud or an intentional breach of fiduciary duty by the directors has been alleged with particularity.[14] Fairly read, the complaint contains no such allegations. Accordingly, as explained below, while the Institute is of the view that a uniform federal law of demand is essential in the case of investment companies,[15] Maryland law, even if it applied, would not have changed the result reached by the lower courts.

II. The Court of Appeals' Enforcement of the Demand Requirement is Particularly Appropriate in Derivative Suits Involving Investment Companies

The Institute submits that the decision of the court of appeals requiring shareholder demand in all derivative actions concerning federal claims is firmly supported by the numerous policy considerations articulated by respondent KFS and should be affirmed. In addition, the Institute believes that, for the reasons set forth below, the decision is particularly appropriate as it relates to registered investment companies, and should govern all shareholder derivative actions which assert claims involving investment companies.

Investment companies are extensively regulated by the Commission under the ICA, in order "to eliminate [] conditions which adversely affect * * * the interest of investors."[16] A principal statutory provision enacted to accomplish that goal is a requirement that at least 40 percent of an investment company's board of directors be composed of independent outside directors, that is, directors who are not

14 *See, e.g.*, *Parish*, 242 A.2d 512; *Rosengarten* v. *Buckley*, 565 F. Supp. 193 (D. Md. 1982); *Oldfield* v. *Alston*, 77 F.R.D. 735 (N.D. Ga. 1978); *Danforth*, 742 F. Supp. 1043.

15 *See* Part II, *infra*.

16 15 U.S.C. § 80a-1 (1988). It should be noted that the Commission has, in other contexts, successfully argued before this Court that its extensive regulatory oversight is an important consideration which should be taken into account in determining the parameters of private actions under the securities laws. *See Shearson/American Express, Inc.* v. *McMahon*, 482 U.S. 220, 233-39 (1987) (Commission successfully argued that its extensive regulatory oversight of self-regulatory organizations and their arbitration procedures was adequate to ensure full vindication of the rights of investors in arbitration proceedings). Here, however, the Commission fails to give effect to the fact that it oversees the effectuation of the ICA's independent director provisions.

interested in the company's investment adviser.[17] The Act further requires that a majority of an investment company's board be independent of the investment company's principal underwriter.[18] Since most investment companies employ underwriters that are the same or related to the investment adviser, the Act effectively insures that, in most cases, the independent members of investment companies' Boards constitute a majority of the board of directors.[19] This is the case with the Fund, whose principal underwriter is a KFS affiliate. J.A. 40.

Congress delegated certain special functions to the independent directors, in the sensitive areas of management contracts and financial reporting, in order to protect shareholders from potential abuse of the relationship between investment companies and their advisers.[20] Thus, the independent directors are required to approve the contracts between the investment company and its investment adviser and principal underwriter,[21] to fill vacant independent director positions that occur as a result of an assignment of advisory contracts,[22] and to

[17] 15 U.S.C. §§ 80a-15(a) & 80a-2(19) (1988). *See Burks*, 441 U.S. at 482 ("The cornerstone of the ICA's effort to control conflicts of interest within mutual funds is the requirement that at least 40% of a fund's board be composed of independent outside directors").

[18] *See* 15 U.S.C. § 80a-10(b)(2) (1988). *See also* S. Rep. No. 1775, 76th Cong., 3d Sess. 14 (1940) ("[A] majority of the board of directors of an investment company must be composed of persons who are not * * * principal underwriters of its securities * * * [or] persons affiliated with them."); S. Rep. No. 184, 91st Cong., 1st Sess. 4, *reprinted in* 1970 U.S. Code Cong. & Admin. News 4897, 4901 [hereinafter S. Rep. No. 184] ("Included in this act was a requirement * * * that a majority of the fund's directors be unaffiliated with the fund's principal underwriter.").

[19] *See* S. Rep. No. 184, *supra* note 18, at 4901 ("Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds are unaffiliated with their managers.").

[20] *See, e.g., id.* ("Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser.").

[21] *See* 15 U.S.C. § 80a-15(c) (1988).

[22] *See id.* § 80a-16(b). The assignment of advisory contracts gives rise to vacancies because the Act requires that in the three years following such transfer, at least 75 percent of the investment company's board must be independent of the new investment adviser and its predecessor. *See id.* § 80a-15(f)(1)(A). Directors who are independent at the time of the transfer (and who remain independent after the transfer) will fill any position vacated by interested directors constituting more than 25 percent of the board. *See id.* § 80a-16(b).

select the independent auditor who certifies or signs the investment company's financial statements.[23]

The legislative history of the Act further emphasizes the importance that Congress ascribed to the role of the independent directors of investment companies in protecting shareholder interests. The Chief Counsel for the Study of Investment Trusts and Investment Companies (which was undertaken by the Commission prior to the enactment of the ICA) stated in his testimony that "[i]n order to furnish an independent check upon the management, the provision is made that at least 40 percent of the board must be independent of the management, officers and employees. * * * [T]hat is one of the most salutary provisions in this bill."[24] Consistent with this view, Congress rejected a proposal of the SEC that "would have forced investment companies to seek court approval before settling claims against 'insiders' that could be the target of derivative suits."[25]

When Congress reconsidered the adequacy of the Act's protection of investors in connection with the 1970 amendments to the Act, "Congress consciously chose to address the conflict-of-interest problem through the Act's independent directors section, rather than

[23] *See id.* § 80a-32(a). Commission regulations under the Act further emphasize the primary role of independent directors in protecting shareholders against conflict-of-interest transactions. These regulations require, *inter alia*, that independent directors approve, and review at least annually, procedures governing (i) a mutual fund's purchases of securities from an underwriting syndicate which includes an affiliate, (ii) purchase and sale transactions between affiliated mutual funds, and (iii) brokerage transactions with affiliates. The Commission further requires that the independent directors determine compliance with such procedures on a quarterly basis. *See* 17 C.F.R. §§ 270.10f-3, 17a-7 and 17e-1 (1990). Any payments made by a mutual fund in connection with a distribution of its securities must similarly be made pursuant to a plan that is approved by the independent directors and that is terminable by those directors. 17 C.F.R. § 270.12b-1 (1990).

[24] *Investment Trusts and Investment Companies, Hearings on H.R. 10065 Before the Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC).

[25] *Burks*, 441 U.S. at 484.

through more drastic remedies such as complete disaffiliation of the companies from their advisers or compulsory internalization of management functions."[26] At that time, Congress strengthened the independence of directors by requiring directors to meet the stricter standard of disinterest in a variety of respects,[27] rather than by the sole requirement that they not be affiliated with the fund's adviser.[28] Congress thus determined that the independent director provisions could be used effectively to insure that such directors fulfilled their duty to "supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs."[29]

The role of independent directors in protecting investment company shareholders was noted by this Court in *Burks*, 441 U.S. 471, in which the Court stated: "Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interest of the funds' shareholders."[30] The Court observed that the special functions assigned to the independent directors of mutual funds indicate the confidence of Congress in the directors' abilities to protect shareholders from conflicts of interest with the fund's investment adviser.[31] The Court thus concluded that the independent directors occupy the role of "watchdogs" to "'furnish an independent check upon the management' of investment companies."[32]

[26] *Burks*, 441 U.S. at 483; *see also Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 147 (1966).

[27] *See* 15 U.S.C. § 80a-2(19) (1988); *cf.* 54 Stat. 806.

[28] *See id.* § 80a-2(3). *See generally* S. Rep. No. 184, *supra* note 18, at 4927-28 (discussing the addition of the disinterest standard to the Act.).

[29] S. Rep. No. 184, *supra* note 18, at 4927.

[30] *Burks*, 441 U.S. at 485.

[31] "Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the * * * view that such directors could never be 'disinterested' where their codirectors or investment advisers were concerned." *Id.* at 485 n.15.

[32] *Id.* at 484; *see also Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977), *cert. denied*, 434 U.S. 934 (1977) (independent director provision "designed to place the unaffiliated directors in the role of 'independent watchdogs' who would assure that * * * mutual funds would operate in the interest of all classes of their securities

Other provisions of the Act in no way reduce the significance of the independent directors as the persons charged with primary responsibility for protecting shareholder interests. Although Congress granted shareholders and the Commission the right to bring suit directly for excessive advisory fees under Section 36(b),[33] this right is narrowly circumscribed;[34] it was designed to redress a specific wrong and to supplement the role of the independent directors in a narrow area where Congress determined that such supplementation was appropriate.[35] In fact, Congress engaged in extensive deliberation over the appropriate formulation of Section 36(b) precisely in order to accommodate traditional principles of corporate governance.[36] The extra protections added by Congress in Section 36(b) were in no way intended to detract from the authority of independent directors under the Act or under traditional corporate law principles.[37]

The paramount role that Congress has mandated for independent directors in protecting the interests of investment company shareholders would be given effect by requiring that shareholder derivative actions against an investment company be subject to a uniform requirement of prior demand upon the company's board of

holders, rather than for the benefit of investment advisers, directors, or other special groups.").

[33] *See* 15 U.S.C. § 80a-36(b) (1988).

[34] *See* Part III, *infra*.

[35] *See Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536-41 (1984).

[36] Congress rejected a suggestion by the SEC that fees be tested under a reasonableness standard because this would put the federal government in the role of fee-setter and "supersede the actions of the management, the board of directors, and the shareholders of the business." 115 Cong. Rec. S13,693 (daily ed. May 26, 1969) (statement of Sen. Bennett). In settling upon the language of Section 36(b), Congress thus wanted it to be understood that "[Section 36(b) was] not designed to ignore concepts developed by the courts as to the authority and responsibility of directors," S. Rep. No. 184, *supra* note 18, at 4903.

[37] Indeed, even with respect to litigation under Section 36(b) itself, Congress sought to preserve much of the deference normally accorded directors' decisions by stating that Section 36(b) "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees," and that "approval of the management fee by the directors * * * is to be given such weight as the court deems appropriate." S. Rep. No. 184, *supra* note 18, at 4902-03.

directors. Under the statutory scheme provided, such demands would be considered by a statutorily mandated group of directors who are "disinterested" under the Act, and who are charged with primary responsibility for protecting shareholder interests. Such directors must be presumed to be capable of acting upon a shareholder demand.

The "futility" exception to the demand requirement is at odds with the structure and requirements of the ICA. The fundamental premise of this exception is the existence of a board of directors which, for reasons of self-interest, bias or other disability, is deemed by law to be inadequate or incapable of making an independent and unbiased decision as to whether to initiate suit. This premise necessarily fails in the case of the Section 20(a) claims at issue here involving the relationship between a registered investment company and its adviser. To be consistent with Congressional purpose and policy, it is appropriate that such claims should be presented to and reviewed by the independent directors.

Moreover, allowing the demand requirement in derivative actions brought against investment companies to be circumvented under various state law futility exceptions — several of which have been read as broadly construing "futility" to obtain on a remarkably meager showing[38] would violate the rule articulated by this Court in *Burks* v. *Lasker*, 441 U.S. 471, 479 (1979), that state law may not be applied to federal claims under the ICA where its application would be inconsistent with the federal policy of the ICA. The ICA clearly embodies a federal policy that the independent directors protect

[38] *See Gaubert*, 863 F.2d at 65 (noting that "some courts have used language that reflects acceptance of * * * less rigorous standard for demand futility."); *Rosengarten*, 565 F. Supp. at 197 ("Courts of different states have reached varying conclusions on the question whether a shareholder suing in the place of the corporation must exhaust his internal remedies if fraud by the corporate directors forms the basis of his complaint."); *In re Consumers Power Co. Derivative Litig.*, 111 F.R.D. 419, 423 (E.D. Mich. 1986) (noting that Delaware law allows plaintiffs to establish futility by alleging *either* a breach of the duty of loyalty *or* a breach of the duty of care, while federal courts apply a "stricter standard" requiring a plaintiff to establish a breach of duty of loyalty); *Zilker* v. *Klein*, 510 F. Supp. 1070, 1073 (N.D. Ill. 1981) ("Courts have not been uniform in their approach to the question whether a demand should be excused * * * [some] courts [ ] have accepted just the bare allegation that demand would be futile.").

shareholder interests in investment companies.[39] When allegations of futility can, in effect, prevent directors from making determinations as to the appropriate disposition of a corporate claim, the directors are rendered unable to fulfill their statutory function. Surely Congress did not intend such a result; indeed, "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet require that they be totally muzzled," without being given an opportunity to do precisely that.[40]

The demand requirement enforced by the court of appeals would, in the case of investment companies, foster the clearly articulated purpose of the Act, the protection of investment company shareholders, and promote uniformity in the Act's administration, a goal which the Commission has, in other contexts, attempted to promote.[41] Congress has unequivocally determined that the independent directors should be the primary protectors of shareholder interests because they are likely to prove the most effective protectors, not only on account of their statutory duties, but also because of their superior knowledge of the relevant facts and the resources of the corporation at their disposal. Demand should thus be required in order to provide the independent directors with an opportunity to assess the appropriate corporate response regarding potential corporate claims.[42]

III. Petitioner has not Stated a "Direct" Section 20(a) Claim

The Commission's use of this case as an opportunity to suggest a radical change in the jurisprudence of proxy claims — that such claims may be asserted only as "direct" claims of shareholders and never as derivative claims — is unfortunate. The Commission ignores the history of the case before it and attempts to reformulate, as a

[39] *See supra* notes 17-37 and accompanying text.

[40] *Burks*, 441 U.S. at 485.

[41] *See* Brief for the Securities and Exchange Commission as Amicus Curiae at 15, *Lampf Pleva Lipkind Prupis & Petigrow* v. *Gilbertson*, 111 S. Ct. 242 (1990) (No. 90-333) ("The securities laws are built around a jurisdictional nexus to interstate commerce or the mails, and were enacted in part because no single State's laws are capable of regulating the Nation's capital markets.").

[42] As the respondent KFS and the Commission agree, issues relating to the standard of judicial review following any rejection of a shareholder demand are not raised here and need not be decided.

"direct" action, a case which was labelled a "derivative" case by the petitioner and pursued as a derivative action in both the district court and the court of appeals.

The Commission's curious proposition is that Section 20(a) claims (and claims under Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78n(a)) are, by definition, *always* direct claims and *never* derivative claims, since, the Commission alleges, these sections do not afford any rights to corporations. This proposition, however, was never asserted by any party to this case over its extended course in the courts below. The court of appeals' notice of the issue[43] does not, in our view, constitute an adequate predicate on which to base a rule of decision in this case, and would deny the parties to this case the opportunity to litigate an issue which belatedly is suggested to constitute the "antecedent" rule of decision.

The Institute submits that the Commission's novel contention is not properly before this Court and, accordingly, should not be considered. However, should the Court conclude to the contrary, the Institute wishes to point out two separate but related problems with the Commission's position. First, with respect to its underlying premise, a "direct" action for damages under Section 20(a), based on the petitioner's allegations, is preempted by Section 36(b). Second, the Commission's reading of the relevant cases to preclude derivative actions for alleged proxy violations is erroneous.

A. Section 36(b) Provides the Exclusive Remedy for Claims Based on Breaches of Fiduciary Duty Respecting Compensation to Advisers

The very nature of the petitioner's proxy claim in this case demonstrates that the Commission's position, that proxy claims are always direct and never derivative, is untenable. The petitioner's proxy claim is based upon a single allegedly misleading statement included in the Fund's 1984 proxy statement relating to the relative amount of fees KFS charged to the Fund. The petitioner did not claim any injury due to the alleged misstatement, and no injury other than on account of the allegedly excessive fees charged to the Fund; she sought no remedy other than a return of such allegedly excessive fees to the Fund. In short, the petitioner's claim under Section 20(a) seeks

[43] Pet. App. 6a-7a.

the precise redress sought in the petitioner's other claim under Section 36(b).

Following the enactment of Section 36(b) of the Act in 1970, however, several courts have ruled that no implied cause of action may be brought under Section 20(a) when such claims relate to excessive fees which may be challenged under Section 36(b).[44] The rationale for this rule is apparent: to allow shareholders to bring excessive fee claims under Section 20(a) would thwart Congressional intent by permitting claimants to erode the procedural and substantive limitations Congress placed in Section 36(b) merely by recasting their claims as violations of Section 20(a).[45]

Prior to the district court's ruling on this issue, only one federal district court had rejected the reasoning of these decisions; that case, however, involved distinct proxy violations which were alleged to have caused distinct harm and where the relief sought encompassed more than return of excessive fees.[46] Although the district court below determined that the petitioner had established a separate Section 20(a) claim, it is submitted that the district court's ruling on this point was erroneous. Allowing a Section 20(a) claim to go forward on the basis

[44] *See Tarlov* v. *Paine Webber Cashfund, Inc.*, 559 F. Supp. 429, 439 (D. Conn. 1983) (holding that "[t]here is no express or implied right of action [under Section 20(a) of the Act] where the alleged violation concerns excessive advisors fees," since "Section 36(b) provides the exclusive method of attacking such fees"); *Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982) (noting in dictum that Section 36(b) may constitute a shareholder's exclusive remedy for excessive fee claims); *Gartenberg* v. *Merrill Lynch Asset Management*, 528 F. Supp. 1038, 1067 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (1982), *cert. denied*, 461 U.S. 906 (1983) (same). *But see Krinsk* v. *Fund Asset Management*, 654 F. Supp. 1227 (S.D.N.Y. 1987), *aff'd*, 875 F.2d 404 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 281 (1989).

[45] *See, e.g.*, *Tarlov*, 559 F. Supp. at 436-39. Congress has thus indicated the manner in which investment company shareholders may recover excessive investment adviser fees on behalf of the investment company.

[46] *Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.*, 622 F. Supp. 169 (S.D.N.Y. 1985) (holding that since the plaintiff alleged "distinct factual allegations of material nondisclosures in particular proxy statements, and seeks legal and equitable relief beyond the mere recapture of excessive fees," such a claim was not "*solely* a breach of fiduciary duty arising from excessive compensation paid to an investment adviser" and, accordingly, could properly be maintained). The district court below applied the reasoning of the *Schuyt* decision, even though the relief sought by the petitioner herein was limited to the return of allegedly excessive fees. Pet. App. 40a-42a.

of the allegations of this case, where no distinct harm was alleged and no remedy, apart from the remedy afforded under Section 36(b), was sought, could result in *all* Section 36(b) claims being brought with related proxy claims, in order to circumvent the procedural rules and substantive limitations imposed by Congress on Section 36(b) actions.

B. If Petitioner's Allegations Could be Construed to State a Section 20(a) Cause of Action, it is Derivative in Nature

The Commission's position that proxy claims may not be derivative is squarely at odds with *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964). There, the Court stated:

> The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the corporation, rather than from damage inflicted directly upon the stockholder. The damage suffered results not from the deceit practiced on him alone but rather from the deceit practiced on the stockholders as a group. To hold that derivative actions are not within the sweep of the action would therefore be tantamount to a denial of private relief.[47]

Despite the Commission's assertions to the contrary (Commission Br. 15 n.9), in *Borak*, this Court clearly recognized the fundamental difference between derivative and direct causes of action.[48] In fact, the Court's discussion of derivative actions recognized the derivative nature of the claim and was in response to the argument of the petitioner in that case that a private right of action under Section 14(a) "would not extend to derivative suits," 377 U.S. at 431. The Court rejected this contention and, in indicating that the denial of a derivative claim would be the equivalent of a denial of relief, emphasized that a derivative action was the principal type of claim that a plaintiff could assert under Section 14(a).

The Commission's reliance on *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1986), is similarly misplaced. *Fox* concerned only "the unusual cause of action created by § 36(b)," 464 U.S. at 535, which, like the cause of action granted to stockholders under Section 16(b)

[47] 377 U.S. at 432.

[48] 377 U.S. at 431.

of the Exchange Act, is unusual in that it expressly provides that a shareholder may assert a claim that is indisputably a corporate claim, without resorting to a derivative action. It in no way supports the assertion that Section 20(a) claims (assuming the existence of a cause of action under this provision) may not be brought by a corporation.[49]

The Commission has also ignored completely *Studebaker Corp.* v. *Gittlin*, 360 F.2d 692 (2d Cir. 1966),[50] which held that a corporation has standing to assert proxy claims under Section 14(a) of the Exchange Act. The *Studebaker* decision has been followed virtually without question;[51] it and its progeny are firmly grounded in this Court's decision in *Borak*. As noted by Judge Friendly in *Studebaker*, 360 F.2d at 695, "[i]f § 27 of the Securities Exchange Act authorizes a stockholder to assert such a claim on the corporation's behalf, as held in *Borak*, it must also authorize the corporation to do so on its own." Thus, actions seeking the dissemination of correct information in proxy materials are generally actions that affect all shareholders and are derivative in nature.

Whether Section 20(a) of the ICA (or Section 14(a) of the Exchange Act) may, in some circumstances, support a direct shareholder action for damages is an issue not presented by this case,

[49] The Commission also argues that in *Piper* v. *Chris-Craft Indus.*, 430 U.S. 1, 32 n.21 (1977), this Court "made clear that the cause of action recognized in *Borak* flows from the violation of all of the shareholders' rights." Commission Br. 14. The cited passage, however, refuted the proposition that, under the circumstances there present and the relevant Supreme Court standards, Section 14(a) would not be found to give rise to an implied right of action. At most, the Court pointed out that the principal beneficiaries of Section 14(a) are "the stockholders as a group"; it in no way stated that corporations do not have the right to protect the rights of "the stockholders as a group" under Section 14(a), just as companies may act to protect other group rights of stockholders.

[50] *Studebaker* overruled *Howard* v. *Furst*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957), which had determined that Section 14(a) of the Exchange Act did not create "any rights whatever in a corporation whose stockholders may be solicited by proxy statements prepared in contravention of the statutory mandate." 238 F.2d at 793. As noted by Judge Friendly, the *Howard* decision was roundly criticized. *See Studebaker*, 360 F.2d at 695 (citing 2 Loss, Securities Regulation 949-50 (1961), and other authorities).

[51] *See, e.g., Airborne Freight Corp.* v. *McPherson*, 427 F.2d 1283, 1286 (9th Cir. 1970); *General Time Corp.* v. *Talley Indus.*, 403 F.2d 159, 161 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

since, as we have shown, the petitioner's damages claim is governed by Section 36(b). Adoption of the Commission's position, however, would be contrary to lower court cases which have permitted actions by corporations to correct misstatements in proxy materials which were disseminated to the detriment of the corporation itself, and all of its shareholders.[52] Rather than promoting the salutary objective of reducing the obstacles to vindication of the interests protected by the law relating to proxy solicitations, the Commission's position would have the opposite effect. By denying to a corporation the standing to bring such claims, the Commission would leave the party which oftentimes suffers substantial harm on account of proxy violations completely without remedy.[53] The Commission's rule ironically would thus deprive shareholders of the right to bring derivative actions, seeking relief that would benefit the corporation, in circumstances where such an action is appropriate.

[52] *See, e.g., Ameribanc Investors Group* v. *Zwart*, 706 F. Supp. 1248 (E.D. Va. 1989); *Pantry Pride, Inc.* v. *Rooney*, 598 F. Supp. 891 (S.D.N.Y. 1984); *Plant Indus.* v. *Bergman*, 499 F. Supp. 376 (S.D.N.Y. 1980); *Management Assistance, Inc.* v. *Edelman*, 584 F. Supp. 1016 (S.D.N.Y. 1984); *National Home Prod., Inc.* v. *Gray*, 416 F. Supp. 1293 (D. Del. 1976).

[53] In this regard, the Commission's assertion that corporations may adequately protect their interests by intervening "as a party under the customary standards for intervention," is without substance. The Commission's position would prohibit corporations from initiating proxy claims, and would reduce the role of the corporation — the party which often is in the best position vigorously to vindicate claims of proxy fraud — to that of merely a nominally interested party.

CONCLUSION

For all of the foregoing reasons, the judgment of the court below, affirming the dismissal of the petitioner's Section 20(a) claim, should be affirmed.

Respectfully submitted,

HARVEY L. PITT*
(*Counsel of Record)
JAMES H. SCHROPP
PETER M. SHERMAN
MARY A. WALLACE
FRIED, FRANK, HARRIS,
SHRIVER & JACOBSON
1001 Pennsylvania Avenue, N.W.
Suite 800
Washington, D.C. 20004
(202) 639-7000

Attorneys for Investment
Company Institute

MATTHEW P. FINK
Senior Vice President
and General Counsel
CRAIG S. TYLE
Associate General Counsel
INVESTMENT COMPANY
INSTITUTE
1600 M Street, N.W.
Suite 600
Washington, D.C. 20036

Of Counsel

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